Has the rise of digitalisation threatened the establishment of taxing rights? A critical analysis of threatened international income tax rules – as robotics, automation and artificial intelligence attempt to destroy the ‘brick and mortar’ principle

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By Jason Daniel

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List of Abbreviations

Abbreviation	Meaning of Abbreviation
4IR	Fourth Industrial Revolution
Act	Income Tax Act, 58 of 1962
AI	Artificial Intelligence
B2B	Business-to-Business
B2C	Business-to-Consumer
BEPS	Base Erosion and Profit Shifting
C2C	Consumer-to-Consumer
Commissioner	The Commissioner of the South African Revenue Service
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation of Intangibles
DTC	Davis Tax Committee
e-commerce	Electronic Commerce
European Commission	European Commission Expert Group on Taxation of the Digital Economy (EU TAX3 Committee)
ICT	Information and Communication Technology
IF	Inclusive Framework
IoT	Internet of Things
IMF	International Monetary Fund
ITA	Income Tax Act, 58 of 1962
LRD	Limited Risk Distributor
MI	Multilateral Instrument
MIP	Marketing Intangibles Proposal
MNE/s	Multinational Enterprise/s
MTC	Model Tax Convention
OECD	Organisation for Economic Cooperative and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital, 2014
OECD Commentary	Commentary of the OECD on the OECD MTC
PE	Permanent Establishment
POEM	Place of Effective Management
Programme of Work/PoW	OECD/G20: BEPS Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, May 2019
SARS	South African Revenue Service
SEPP	Significant Economic Presence Proposal
TFDE	Task Force of the Digital Economy
UPP	User Participation Proposal
WEF	World Economic Forum

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Introduction

The business world has evolved to such an extent that world trade ignores the boundaries of countries with the rise of a digital market place. Cyberspace has rendered the need for concepts such as geographic coordinates and physical presence, redundant.[1] The resultant impact of digitalisation has forced states to rethink archaic principles in light of this digital transformation and its effects on tax law.[2] Tax systems that prescribe a physical presence test are required to conceptualise the concept of 'virtual presence' and its bearing on destroying country sovereignty,[3] as the international tax system becomes increasingly obsolete.[4] Multinationals are able to proliferate the current void in the system and capitalise on digitalisation by shifting their profits to lower tax jurisdictions while at the same time continuing to conduct businesses in higher tax jurisdictions.

Given the speed with which digitalisation has spread across the globe, coupled with the changes that might occur by future technologies, such as collaborative economy, blockchain, artificial intelligence and robotics, the current system is not fit to catch up with today's economic realities.[5] The traditional rules that place reliance on a 'physical link' are ill-equipped to match the realities of the highly mobile and borderless digital economy.[6] Digitalisation is challenging the identification of locating value creation, the allocation of profits and the *nexus* principle. According to the Organisation for Economic Cooperation and Development ("OECD"), Inclusive Framework on Base Erosion and Profit Shift ("BEPS"):

> "[o]ne of the implications that has been at the centre of the recent global debate is whether or not the international income tax rules continue to be 'fit for purpose' in the modern global economy where new and often intangible value drivers come to the fore, and physical distances are losing their relevance."[7]

[1] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD.
[2] Oguttu & Van der Merwe "Electronic Commerce: Challenging the Income Tax Base?" (2005) 17 SA Merc LJ at 305.
[3] Oguttu & Van der Merwe (n2) above.
[4] MS Sunita Manik, Group Executive of the South African Revenue Service (SARS) Large Business Centre.
[5] Schippers and Verhaeren "Taxation in a Digitizing World: Solutions for Corporate Income Tax and Value Added Tax" (2018) *EC Tax Review* 64.
[6] De Graaf and Visser "BEPS: Will the Current Commitments and Peer Review Model Prove Effective?" (2018) *EC Tax Review* 36.
[7] OECD statement made on "Action 1: Tax Challenges Arising from Digitalisation" available at https://www.oecd.org/tax/beps/bepsactions/action1/.

An agreed timeline to develop a long-term consensus-based solution is set for the end of 2020. The impact digitalisation has on the fundamental aspects of the international tax system is vast and the ambitious timeline is indicative of the fact that all members of the Inclusive Framework consider finding a timely resolution to the issues at stake imperative.[8] For the sake of brevity, the current issue can be broadly and succinctly attributed to the marked rise in the international nature associated with the production of goods and services, coupled further by the effects of 'servicification' and digitalisation.[9] The concerns are centered around global and complex business value chains where important business functions related to goods, services and intangibles are difficult to establish or locate. Attention is being focused on the determination of the *nexus* (tax liability of the taxpayer in a specific tax jurisdiction) and the associated allocation of taxing rights to jurisdictions, inclusive of the tax bases to be considered in each jurisdiction (the apportionment and allocation of assets or income to a specific jurisdiction).[10]

The Programme of Works,[11] The European Union[12] and Davis Tax Committee[13] have put forward and explored several options to address the challenges digitalisation has on taxation which will be further detailed in this study. The potential tax reforms developed, include new profit allocation rules "the new taxing right requires a method to quantify the amount of profit reallocated to market jurisdictions and a method to determine how that profit should be allocated among the market jurisdictions entitled to tax under the new taxing right."[14] The potential solutions include, *inter alia*, supply-side orientated global profit splitting systems, supply-side or demand-side global formulary systems, destination-based cash flow taxes and taxation of Multinational Enterprises ("MNEs") solely in the ultimate parent jurisdiction.[15] According to the OECD they are exploring the modified

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[8] OECD Statement (n7) above.

[9] Clavey "International Tax Reform, Digitalization and Developing Economies" October 2019, at 5 available at http://documents.worldbank.org/curated/en/735001569857911590/International-Tax-Reform-Digitalization-and-Developing-Economies.

[10] Clavey (n9) above.

[11] OECD "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" (May 2019) available at https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf

[12] EU TAX3 Committee "Impact of Digitalisation on International Tax Matters – Challenges and Remedies" available at http://www.europarl.europa.eu/cmsdata/161104/ST%20Impact%20of%20Digitalisation%20publication.pdf

[13] The Davis Tax Committee Second Interim Report on Base Erosion and Profit Shifting in South Africa available at https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf.

[14] OECD May 2019 (n11) above at 12.

[15] OECD May 2019 (n11) above at 12 – 23; See also EU TAX3 (n12) above at 74 – 81.

residual profit split method,[16] fractional apportionment method,[17] distribution-based approaches.[18] The OECD further discusses the establishment of new *nexus* rules to develop a new non-physical presence *nexus* rule to allow market jurisdictions to tax the measure of profits allocated to them under the new profit allocation rules.[19]

Given the stagnant nature of international tax rules over the last ten years and the rise of the Fourth Industrial Revolution ("4IR"), it is high-time that fundamental changes to international tax principles are undertaken to counter legal arbitrage opportunities by MNEs and ultimate BEPS. In this study, an exploration will be undertaken to explore the key features of the digital economy, with a specific focus on the effect digitalisation has had on age-old South African tax rules. An investigation into the various proposals to remedy the effect that digitalisation has on the tax world will be undertaken, including the impact these proposals may have on a developing economy, such as South Africa. For the purposes of the discussion below, a substantial focus on Pillar One will be undertaken, the reasoning behind the focus on Pillar One that there has not been competing approaches, whereas Pillar One requires a unification of the approaches.

[16] OECD (May 2019) (n11) above at 12.
[17] OECD (May 2019) (n11) above at 14.
[18] OECD (May 2019) (n11) above at 15.
[19] (n18) above.

2. The Digital Economy

2.1. Introduction

According to the International Monetary Fund, the "digital economy" is sometimes defined narrowly as online platforms and activities that owe their existence to such platforms, but in the broad sense, all activities that use digitalised data are part of the digital economy, in modern economies this impacts the entire economy.[20] The digital economy has grown exponentially with the rapid diffusion of digital technologies at an unprecedented proportion, while the entire economy is going digital.[21] The McKinsey Global Institute has remarked how innovation and the huge surge in the volumes of data gathered from digital platforms, sensors and smart phones has transformed and digitalised 'traditional' sectors of the economy such as retail, manufacturing, financial services, healthcare, media, education and the automotive and transport industries.[22] The capacity for storage, computing power and more sophisticated algorithms further modify these aforementioned sectors.

Defining what constitutes the digital economy has proven problematic, because of the ever-changing technologies of the Information and Communications Technology ("ICT") sector and the widespread diffusion of the digital economy within the whole economy.[23] The digital economy is best described at the hand of a number of its key features, which include mobility, the high use of data, and multisided business models.[24] Digitalisation has changed the nature of business including innovation, product development as well as interactions between producers and consumers. The 4IR, as the digital era has been dubbed, has given rise to new digital business models as a consequence of Artificial Intelligence (AI), the Internet of Things (IoT), virtual intelligence, adaptive manufacturing and autonomous supply chains.[25] The mobility of the digital economy has led to borderless limitations. In turn, a number of products and services have

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[20] International Monetary Fund (2018) "Measuring the Digital Economy" available at https://www.imf.org/~/media/Files/Publications/PP/2018/022818MeasuringDigitalEconomy.ashx.

[21] European *Commission Report of the Commission Expert Group on the Impact of Digitalisation on International Tax Matters* ("European Commission 2019 Report") at 14.

[22] McKinsey Global Institute (2016) "The Age of Analytics: Competing om a Data-Driven World" available at https://www.mckinsey.com/business-functions/mckinsey-analytics/our-insights/the-age-of-analytics-competing-in-a-data-driven-world.

[23] Booz & Company "Digitalization for Economic Growth and Job Creation: Regional and Industry Perspectives" See also OECD / G20 BEPS Project Addressing the tax challenges of the digital economy Action: 2015 Final Report ("OECD Digital Economy Report") at 52.

[24] EU TAX3 (n12) above at 11.

[25] EU TAX3 (n12) above at 14 – 22.

increased in mobility, particularly with the reduced cost of storing and transporting these products and services.[26] Companies are therefore able to operate virtually anywhere across the globe, often with no physical presence within the markets it operates and generates profits, often resulting in no taxable presence in these countries.[27]

It is apparent that across all sectors within the economy at large, MNEs to start-up businesses have transformed their business models through the adoption and implementation of ICT.[28] This has seen enhancement in productivity with an enlarged market reach and the reduction in operational costs. Furthermore, technological advancements have changed the way businesses produce products or deliver services, businesses are able to leverage global value chains from anywhere in the world with no geographical limitations.[29] The 4IR has bulldozed the principles of the traditional economy that was built on the foundations of "brick and mortar" business models and international tax rules.

2.2 Key features of the digital economy

When considering the key characteristics of digitalisation, insofar as they create tax challenges, the following features should be considered, namely:

2.2.1 *Mobility*

Given the marked increase in the mobility of intangibles, users and business functions, an organisation's need for a physical presence, with local personnel has drastically declined. The challenge associated with such mobility is the determination of where value is added and where the source of income is situated. Consistent with mobility is its interrelation with flexibility where the digital economy allows companies to choose the location of the company servers and business resources.[30]

2.2.2 *A reliance on data*

[26] EU TAX3 (n12) above at 15.
[27] (n26) above.
[28] OECD Digital Economy Report (n23) above at 52, See Also EU TAX3 (n12) above at 17 -21.
[29] (n28) above.
[30] OECD Digital Economy Report (n23) above at 65. See Also De Bruyn "A Comparative Analysis of the Projects Undertaken in the Development of a Taxation Framework in the Digital Economy" 2016 Minor dissertation from the University of Cape Town at 6.

In the age of digitalisation, reliance on data, and specifically the use of customers personal data, is invaluable. MNEs utilise this data for targeted advertising or marketing purposes and/or targeted service offerings. These targeted activities are often custom designed for specific jurisdictions and are of essential value to MNEs value chain. The test for tax authorities brings into question, whether there should be a value attached to this data and if so, how to calculate the actual value of such data.[31]

2.2.3 *Multi-sided business models*

Under this model, several groups of persons interact through an intermediary or platform and the decisions made by each group consequently affects other groups within the multi-sided business model. In the 4IR an example of such a model involves an operating system that increases in value to end users/consumers if multiple developers write software for the operating system and similarly, more valuable to software developers, if more potential software purchasers use the operating system. Accordingly, the value of profits of an enterprise is often dependent on or attributable to the value of another enterprise.[32]

2.2.4 *Monopoly or oligopoly*

Monopoly or oligopoly is created whereby a select few market players are capable of having a dominant position in an immature market for a short period of time, due to the network effects combined with low incremental costs. This dominant position is further enhanced in instances where a patent is granted to a specific business with the exclusive power to exploit such an invitation.[33]

2.2.5 *Volatility*

The high volatility rate stems from the digital economy's low barriers of entry. Internet availability is accessible globally, without large start-up costs resulting in a miniaturised market. Businesses dominance is short lived as aggressive competition rules the digital market, as businesses put

[31] De Bruyn (n30) above at 7.
[32] OECD Digital Economy Report (n23) above at 71; See De Bruyn (n64) above at 7.
[33] De Bruyn (n30) above at 7.

forward better value adding proposals or sustainable business models. The volatility levels have left few companies capable of securing long term success within the digital economy in the 4IR.[34]

2.3. New business models in the digital economy

Digitalisation and the technological advancements in the area of ICT have given birth to multifaceted business models within the digital economy. These models have the features of traditional business models, however, ICT has allowed business to conduct their operations anywhere in the world and from virtually anywhere in the world. The OECD's Digital Economy Report examines some of the new business models[35]:

2.3.1 *Electronic Commerce ("e-commerce")*

E-commerce encompasses two broad themes, firstly, the purchase of goods and services online that are then physically delivered through traditional means (for e.g. *Takealot*) and secondly, the purchase of goods and services that remain entirely electronic (for e.g. *online gaming*).[36] The three key business models within the e-commerce sphere are Business-to-Business models (B2B), Business-to-Consumer models (B2C) and Consumer-to-Consumer models (C2C).[37]

E-commerce has been broadly defined as:[38]

> "[t]he sale or purchase of goods or services conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered in those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments and other public or private organizations."

2.3.2 *Payment services*

[34] OECD Digital Economy Report (n23) above at 73; See De Bruyn (n30) above at 8.
[35] See also EU TAX3 Digital Economy Report, 2019 (n12) above at 17 -21.
[36] OECD (2011) OECD Guide to Measuring the Information Society 2011, OECD Publishing, Paris.
[37] De Bruyn (n30) above at 8.
[38] OECD (2011) (n36) above.

Developments in the ICT space have created online cash payment solutions including e-wallets, mobile payment solutions and virtual currencies. In terms of this business model, the payment service provider usually acts as an intermediary, utilising a "software-as-a-service" model, between the parties to the transaction.[39] These advancements by online payment service providers have allowed for anonymity where online users can make secure online payments without sharing specific, financial, bank or credit card information to each vendor when effecting payment for goods and/or services.

2.3.3 *Application Stores ("app-stores")*

Given the ease and accessibility of the internet by consumers, through the use of smart devices, the frequency and use of online services and the development of app-stores has rapidly increased, further contributing to the rise of the digital economy.[40] App-stores constitute a digital distribution platform for software. The framework around app-stores would encompass a process whereby the consumer accesses a central retail platform on their smart devices, whereby the user is capable of browsing, making purchases, downloading and subsequently installing applications on their device.[41] The content available on app stores may either be developed by the business operating the app store, the business manufacturing the device or by a third party. The foundational cornerstones of an app-stores business model include free apps, "freemium" apps in which basic functionality is provided for free but users pay for additional content and features.[42] The functionality of apps are supported and funded through in-app advertising. These app-stores are intended to service specific geographical markets with the aim of designing apps on these stores to function within a global market, including the cross listing of apps on various app stores.[43]

2.3.4 *Online Advertising*

The sophistication and change within the advertising space is significantly prevalent in the digital economy. Traditional marketing falls short of the advantages created by effective online advertising within the digital age. Advertisers and MNEs take advantage of their access to large

[39] OECD Digital Economy Report (n23) above at 57.
[40] OECD Digital Economy Report (n23) above at 58.
[41] OECD Digital Economy Report (n23) above at 58.
[42] De Bruyn (n30) above at 9.
[43] OECD Digital Economy Report (n23) above at 58.

user bases with sophisticated algorithms to collect, analyse, and process data in order to create targeted advertisements.[44] The forms of advertising in the modern age include digital ads, search engine ads and content ads. The players in the online advertising value chain includes web publishers, advertisers and advertising intermediaries. The advertising intermediaries connect web publishers and advertisers and include search engines, media companies and technology vendors.[45]

In terms of the advertising-based business models, web publishers of content are often willing to provide free or subsidised services to clients in order to establish a large consumer audience and thereby attract advertisers to the online platform of the web publisher.[46] The cost of traditional forms of advertising is built on the prominence and time the advert is displayed. Under traditional advertising there is very little way of monitoring the user response to the said ad. The 4IR has adapted online advertising, in terms of which advertisers pay per display of the ad to the consumer; the cost per click model in terms of which advertisers only pay when users click on the ad; and the cost per action model in terms of which advertisers pay only when a specific action is completed by a consumer.[47]

2.3.5 *Cloud Computing*

Cloud computing is the provision of on-demand online computer services which includes computing, data management, storage and software using shared physical and virtual resources, such as networks, servers and apps.[48] Cloud computing user have unperilled access to a wealth of resources hosted on many networked computers. Cloud computing has enabled users with a cost-effective alternative to maintain its own IT infrastructure. Cloud computing is driven by economies of scale, which involves setting up the infrastructure and maximising server usage by sharing space between users.[49]

[44] (n43) above.
[45] OECD Digital Economy Report (n23) above at 59.
[46] (n45) above.
[47] (n45) above.
[48] OECD Digital Economy Report (n23) at 60.
[49] (n48) above.

2.4. **Diversity of Revenue Models**

The diversification of business models within the digital economy have substantially transformed the way value is generated into revenue. In the 4IR common revenue models include, *inter alia*,[50] (i) advertising-based revenues, which provide free or discounted content is provided to users with advertisements imbedded in the content.[51] (ii) digital content purchases or rentals, through e-books, music, apps and videos where users pay per download of the content.[52] (iii) selling of goods, businesses offer physical or virtual goods for sale on an online platform.[53] (iv) Subscription-based revenues – users can subscribe for digital content such as music, software and news at a weekly or monthly subscription premium.[54] (v) Selling of services – users can purchase services on an online platform, the services may include traditional services such as legal or financial services or digital services such as internet access services and web hosting services.[55] (vi) Licensing content and technology – users can license or purchase online content such as software, cloud based operating systems and algorithms.[56] (vii) Selling of user data and customized market research.[57] (viii) "Hidden" fees and loss leaders – integrated businesses may attribute profits or losses to online operations, but because of the high level of business integration, cross-subsidy with other operations occur and it is difficult to identify the online revenue. This would include "free" online banking, which is subsidised through other banking operations and fees.[58]

2.5 **Conclusion**

In light of the vast developments in the space of ICT and technology, traditional business models based on the 'brick and mortar' principle have deteriorated. With unrestricted access to a global user base, without the need for a physical presence within a jurisdiction, businesses have become digitally fit and their business models are reflective of this change.[59] Concerns are raised

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[50] OECD Digital Economy Report (n23) above at 60 – 64.
[51] (n50) above.
[52] (n50) above.
[53] (n50) above.
[54] (n50) above.
[55] (n50) above.
[56] (n50) above.
[57] (n50) above.
[58] (n50) above.
[59] EU TAX3 Digital Economy Report, 2019 (n12) above at 13.

surrounding whether the existing taxation framework is adequate to address these highly digitalised business models.[60] By applying the traditional principles of source and permanent establishments ("PE"), businesses might well not be taxed where the economic value is created or where the profits are derived.

[60] EU TAX3 Digital Economy Report, 2019 (n12) above at 17.

3. Overview of South Africa's Jurisdiction to Tax and the 4IR

3.1 South Africa's jurisdiction to tax the income of natural persons

3.1.1 *'Ordinarily resident'*

The term '*ordinarily resident*' is not defined in the Income Tax Act ("ITA")[61] and reliance is therefore placed on case law that has extensively explored the term. It can be said that an individual is 'ordinarily resident' in South Africa if he or she is living in South Africa with some degree of continuity.[62] In *Cohen v CIR*[63] the Court expressed that a person's ordinary residence "would be the country to which he would naturally and as a matter of course return from his wanderings". In *CIR v Kuttel*[64] the Court remarked that 'ordinary residence' would be the country that a taxpayer might call their "usual or principal residence and real home". Regard should be had to *ITC 1185*[65], that details that ordinary residence requires presence together with the intention to live in a particular place with a degree of permanence.[66] It can be said to be the place where a person maintains his ordinary life with its 'accessories in social relations, interests and conveniences.'[67] With the rise of technology taxpayers are able to carry out many facets of their lives in various jurisdictions by acquiring a 'presence' in cyberspace. Digitalisation should not affect a taxpayer's 'ordinary residence' as a taxpayer cannot permanently reside in cyberspace. *Oguttu* remarks that "an individual's cyberspace activities are undertaken from a real chair, in front of a real computer, all connected to the physical location where the taxpayer "lives" in real life."[68]

3.1.2 *'Physical presence'*

In the instance where an individual does not satisfy the 'ordinarily resident' test, that individual will be resident in South Africa if the requirements for the 'physical presence' test are met. The

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[61] 58 of 1962.
[62] *Levene v IRC* (1928) AC 2117 (HL(E)); See *H v COT* 1962 24 SATC 738.
[63] 1946 13 SATC 362.
[64] 1992 54 SATC 298.
[65] 1972 35 SATC 122.
[66] SARS Income Tax Interpretation Note 3 available at https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-03%20-%20Resident%20definition%20natural%20person%20ordinarily%20resident.pdf.
[67] *Thompson v Minister of National Revenue* 1946 (2) DTC 812 (SC, Can).
[68] Oguttu & Van Der Merwe (n2) above at 308.

numerical residence rules are detailed in Section 1 of the ITA. Academics have suggested that with the rise of technological advancements, manipulation of the numerical residence rules are possible.[69] Taxpayers could attempt to absent themselves from a specific jurisdiction for the required period while maintaining employment through telecommunication from another jurisdiction.[70] Although, theoretically possible, this lifestyle would be virtually impossible to maintain, purely for the purposes of tax avoidance.[71]

3.2 South Africa's jurisdiction to tax the income of persons other than natural persons

Juristic persons are resident in South Africa if they are incorporated, established or formed in South Africa, or if they have a 'place of effective management' ("POEM") in South Africa.[72] The former is a straightforward technical determination that is easily ascertainable and verifiable through the Registrar of Companies. The latter principle of POEM is, however, open to interpretation and manipulation as the principle is not defined in the ITA.

According to SARS, the POEM of a company is the place where key management and commercial decisions that are necessary for the conduct of business as a whole are in substance made.[73] The POEM is the place and/or places[74] where strategic decisions are taken or adopted, as opposed to the place where strategic decisions and policies are executed and implemented.[75] The POEM will ordinarily be the place where the most senior group of persons make decisions and where the actions to be taken by the entity, as a whole, are determined. This approach is consistent with the OECD Model Tax Convention.[76] Given the technological developments in the 4IR – changes in telecommunications, information technology, global travel and modern business

[69] SARS Income Tax Interpretation Note 4 available at https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-04%20-%20Resident%20definition%20natural%20person%20physical%20presence.pdf.
[70] Doernberg, Hinnekens, Hellerstein & Li *Electronic Commerce and Multijurisdictional Taxation* (2001) 302.
[71] Oguttu & Van der Merwe (n2) above at 309.
[72] Section 1 of the Income Tax Act 58 of 1962.
[73] SARS Income Tax Interpretation Note 6 available at https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf.
[74] *Oceanic Trust Co Ltd NO v CSARS* (2012) 74 SATC 127; See *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor* (2010) EWCA Civ 778.
[75] OECD "The impact of the communications revolution on the application of "place of effective management" as a tie breaker rule" (2001) available at http://www.oecd.org/tax/treaties/1923328.pdf
[76] Section 233 of the Constitution of South Africa, 1996; Model Tax Convention on Income and on Capital: Condensed Version 2017 available at https://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm.

practices, could all affect the interpretation of the POEM principle. Modernisation and global travel have meant that physical meetings of the board are no longer required and key directors with decision-making powers sit in various jurisdictions while attending the physical meeting through video conferencing, leaving a situation where the physical location of the meeting may not be where key management decisions are being made, it is therefore imperative that reliance should not be placed on the location of board meetings in isolation.[77] The 4IR has created a complex balancing activity when establishing the POEM of an entity, that is likely to evolve and be disputed in our courts in the future.

The manipulation of the POEM is enhanced by the 4IR, *Kohl* remarks that "the Internet provides the information and opportunities necessary to make residence more a matter of deliberate choice rather than fate."[78] If a company avoids day-to-day management in a specific location through the use of modern technology, then, in terms of the SARS' approach, the POEM will be where the business operations are actually carried out. In the sense of traditional business operations, where the sale of tangible products are actually being carried out, the manipulation of the POEM principle is less likely to be manipulated as opposed to intangible products and services that are being provided by multiple parties from multiple jurisdictions all facilitated through an intricate online web application, through the use of modern digital infrastructure platforms, such as 'the Cloud'.

3.3 South Africa's jurisdiction to tax the income of non-residents

Non-residents are taxed on income from a 'source' in South Africa. The term 'source' is not defined in the ITA and the interpretation of the concept of 'source' is denoted from case law. In *CIR v Lever Brothers & Unilever Ltd*[79] the court expressed that the source of the income is established by first determining the originating cause and by locating that cause. Digitalisation will affect the two fundamentals of this analysis, firstly, the characterisation of income and secondly, the geographical location of a taxpayer's activities.[80]

[77] SARS (n73) above.
[78] Uta Kohl "The Horror-scope for the taxation office: The Internet and its Impact on Residence" (1998) 21. University of New South Wales LJ at 436.
[79] 1946 AD 441.
[80] Oguttu & Van der Merwe (n2) above at 311.

3.3.1 *Characterisation of Income*

Dependence is placed on the distinction between the nature and character of different types of income or the ability to characterise a specific type of income to ascertain the type of tax applicable to that income. Digitalisation impacts the way in which business and transactions are concluded as it creates new avenues for providing marketing, sales, delivery and customer support and the ability to supply digital products/services.

The challenges with today's digitalised business is that the nature of electronic products/services are disguised, "services such as the provision of a database, online subscriptions, or the downloading of software may result in either income for the performance of a service, a royalty for the use of a copyrighted intangible, or profit from the sale of a product."[81] The concerns surrounding the characterisation of income derived from electronic commerce have been highlighted by the OECD. Under most tax treaties, business profits would be taxable in a country only if attributable to a PE located therein. In contrast, royalties may be subject to withholding tax in the country of the payer, depending on the terms of any applicable treaty.[82] It has been advised that when considering the characterisation of income derived from e-commerce it will be necessary to examine the rationale behind existing rules, in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms.[83]

3.3.2 *Locating the source of certain types of income*

Conventionally, a relationship existed between the geographical location of a taxpayer's income generating activities and the location of the originating cause thereof. However, that relationship has soured in the 4IR, as taxpayers are able to generate income without substantially using infrastructure in any given physical location.[84] Digitalised businesses have the capability to spread their various business functions across various jurisdictions to yield the greatest return on investment and service the needs of remote customers. It would appear that in the 4IR, a greater need for apportionment between jurisdictions, may well be needed.[85]

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[81] Buys and Cronje *Cyber Law: The Law of the Internet in South Africa* (2004) 305.
[82] Oguttu & Van der Merwe (n2) above at 312.
[83] (n83) above.
[84] Oguttu & Van der Merwe (n2) above at 314.
[85] ITC 77 (1928) 3 SATC 72.

Where an OECD Model Treaty applies, the business income from services or the sale of movable goods is generally dealt with under the principles used for the taxation of business profits, as the Model Treaty does not provide specifically for these types of income. Regard should be had to *CIR v Epstein,*[86] where the Court provides that the originating cause of income from services rendered is the service or the work and it is located where the service is performed or rendered, or the work done. Digitalisation will further exacerbate an already contentious issue where electronic services are provided in various jurisdictions, with each claiming jurisdiction to tax the service income. Given the inherent difficulty in locating the source of internet-based services, *Oguttu* comments that a distinction may have to be drawn between several variables, for instance where the input is produced, where the server provides the input to the customer or where the program interacts with the customer.[87]

In the context of income from the sale of movable goods, attention must be drawn to *Transvaal Associated Hide & Skin Merchants (Pty) Ltd v Collector of income Tax (Botswana)*[88] that details where the 'activities' of the seller are spread across more than one jurisdiction, the location of the 'dominant' activity should determine the source. The interpretation and application of the principles of 'activities' and 'dominant cause' will increasingly prove to be difficult in the era of the 4IR, specifically where non-resident traders sell intangible and/or digitised products that maintain their status in cyberspace. An assessment of the transaction would need to entail what functions were performed by the seller and the purchaser, what the location of the originating cause is, and what activities performed by each of the party can be seen as the 'dominant cause' and where are these functions performed.[89]

3.3.3 *Permanent Establishments and the 4IR*

Tax authorities worldwide are directing their attention on MNE business activities and permanent establishments. This attention results from claims that the permanent establishment (PE) concept is outdated given modern day global trends. Further manipulation of the PE concept has been created by exploiting the use of seemingly independent agents, splitting of contracts and the

[86] 1954 (3) SA 689 (A).
[87] Oguttu & Van der Merwe (n2) above at 315.
[88] (1967) 29 SATC 97.
[89] (n88) above.

fragmentation of activities to fall within the definition of activities that were “auxiliary” or “preparatory” in nature.[90] In the era of the 4IR MNEs can operate a global business electronically, enabling MNEs to provide electronic services in almost any jurisdiction and to further engage in online marketing, while their employees have the capability to work remotely across the globe. The 4IR has made it possible for an enterprise to operate completely online, without the need for a fixed place of business at its disposal, while providing electronic products/services to its clients in various jurisdictions. This creates difficulties in the world of tax because digital companies engaging in such activities often do not fall within the definition of a PE.

The ITA defines the term PE with reference to Article 5(1) of the OECD MTC, where a PE means: “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. If an enterprise has developed a taxable presence in the source state, by way of conducting activities in that state, the business profits derived therefrom are taxable due to the creation of a PE. In accordance with the OECD MTC Commentary there must be a “fixed” place of business,[91] in that there must be a degree of permanence[92] to such place of business, and the place of business must be at the disposal of the enterprise where business activities are wholly or partly being conducted.[93]

The Multilateral Instrument (MI) was developed by the OECD pursuant to the recommendations contained in Action 15 of the BEPS Report[94] the MI is an effective means to update bilateral tax treaties between states who are signatories to the MI.[95] Subsequent to Article 12 of the MI the definition of PE was broadened (not adopted by South Africa). Given the broadened definition of PE, a PE no longer simply arises where a dependent agent has the authority to conclude contracts on behalf of the enterprise. It will also arise where an agent continually plays a principal role in the conclusion of contracts, and such contracts are concluded without substantial or any modification by the enterprise concerned.

[90] Article 4 & 5 of the 2017 OECD MTC.
[91] Paragraph 5 of the Commentary of Article 5(1) of the OECD MTC.
[92] *Formula One World Championship Ltd vs Commissioner of Income Tax* (2017) 291 CTR 24 (Delhi).
[93] Article 5(2) and 5(4) of the OECD Model Treaty.
[94] Action 15 of the BEPS Report available at https://www.oecd.org/ctp/beps-2015-final-reports.htm.
[95] As at 28 June 2019, 89 jurisdictions were signatories to the Multilateral Instrument; See: Oguttu “Should Developing Countries Sign the OECD Multilateral Instrument to Address Treaty Related Base Erosion and Profit Shifting Measures?” (2018) CGD Policy Paper available at https://www.cgdev.org/sites/default/files/should-developing-countries-sign-oecd-multilateral-instrument-address-treaty-related.pdf.

States have voiced concerns regarding the current system of taxation, that provides that a MNEs business profits are only taxed if it has a physical PE in the State concerned. In the 4IR MNEs are able to participate in the economic activities of various states, without having a 'fixed place of business' in these states. MNEs are conducting digital business activities in various jurisdictions while simultaneously escaping the tax net. The difficulties arise when attempting to prove a jurisdictional *nexus*, and the determination of the attribution and allocation of profits. The 4IR has increased the difficulty for taxing authorities to ascertain: where value creation truly lies; in identifying the true source of the income; in which tax jurisdiction it actually occurs and what aspect of the digital transaction creates value.[96]

96 Macdonald-Spence "Latest Global Trends in Permanent Establishments" (2019) TaxTalk 32.

4. Analysis of Tax Challenges Arising from the Digitalisation of the Economy: an OECD perspective

4.1 Background

MNEs have capitalised on the aggressive nature of digitalisation coupled with creative tax planning schemes to shift profits to low-tax jurisdictions placing surmounting pressure on tax administrations to ensure fair taxation.[97] Various business models are evolving with the advances in technology, as illustrated above. The outdated international tax system, based on the physical condition of a connecting link to assert jurisdiction for taxation purposes, is ill-equipped to handle highly mobile, intangible and multi-faceted digitalised businesses[98] and products. The 'physical presence' of an entity is becoming an obsolete phenomenon, in the age of the 4IR. However, any departure from the *nexus* principle, which 'forms part of general international law of income tax jurisdiction', deeming both a personal and territorial link necessary for income taxation, may question the very essence of statehood and state sovereignty.[99] Digitalisation is challenging the identification of locating value creation, the allocation of profits and the *nexus* principle.

The OECD recently published a "Programme of Work"[100], two key "Pillars" emerged from the Programme, firstly, the re-allocation of profit and revised *nexus* rules and secondly, global anti-base erosion mechanism. The proposals by the OECD aim to typically allocate more taxing rights to market or user jurisdictions where value is created through businesses' participation in the user or market jurisdiction, that is not recognised in the current framework for allocating profits.[101] In terms of profit allocation, the OECD intends to embark on an examination of various methods[102] to determine how much of a MNE's profit should be allocated to market jurisdictions and how to

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97 Luxembourg Leaks; Panama Papers; Paradise Papers available at https://www.icij.org/investigations/panama-papers/lux-leaks-panama-papers-spur-eu-to-better-protect-whistleblowers/.

98 Key features of digitalised companies include reliance on network effects, user participation and user generated consent.

99 European Parliament "Impact of Digitalisation in International Tax Matters" TAX3 Committee (2019) available at http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU(2019)626078.

100 OECD (May 2019), *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, available at www.oecd.org/tax/beps/programme-of-work-to-develop-aconsensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

101 Laid out by the 129 members of the OECD/G20 Inclusive Framework on BEPS, May 31, 2019 and endorsed by G20 Finance Ministers in Fukuoka, Japan on 9 June 2019.

102 Modified residual profit split method; fractional apportionment method and distribution-based approaches.

then allocate that profit among those market jurisdictions. The OECD further aims to consider a new “non-physical presence *nexus* rule” – this rule would require remote but sustained and significant business presence at the MNE group level and could consider *inter alia*, revenue thresholds, targeted marketing activities and digital engagement in the jurisdiction. The global anti-base erosion rules are generally intended to ensure a minimum level of tax is being paid by MNE’s, under the proposals[103] considered by the OECD the various rules, could provide jurisdiction with the ability to “tax-back” profits that are subject to low effective rates of tax. The OECD confirms the international community’s continued commitment to reach a consensus-based long-term solution on taxation and the global digital economy by 2020. The work programme, endorsed by the G20 finance ministers in June 2019, addresses issues, including the reallocation of taxing rights, significant economic presence, minimum taxation and dispute resolution and organises them into two pillars.

Having regard to various initiatives undertaken by the OECD, namely: OECD (2015)[104]; OECD (2018)[105]; OECD (January 2019)[106]; OECD (February 2019)[107]; OECD (May 2019)[108] and OECD (October 2019)[109] in an attempt to limit the tax challenges associated with digitalisation, two key pillars emerged from the OECD’s publications. In short, *Pillar One*: *Re-allocation of profit and revised nexus rules*: Pillar One aims to provide potential solutions to ‘profit allocation’ with regard to the apportionment of profits in various jurisdictions where users clients are located and further explores the ‘*nexus’* principle in light of where and on what basis tax should be paid.[110] The purpose of such an examination aims to determine whether the OECD has achieved a viable solution to the tax challenges arising from digitalisation and whether the “new *nexus* rules” and “profit allocation” rules effectively address the uncertainties as created by digitalisation. *Pillar Two: Global anti-base erosion mechanism*: potential ‘new tools’ are provided to countries to protect their tax base from profit shifting in the digital economy with a particular focus on multinational

[103] An inclusion rule; a switch-over rule; an undertaxed payment rule and a subject to tax rule.
[104] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[105] OECD (2018), *Tax Challenges Arising from Digitalisation* – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[106] OECD (2019), *Addressing the Tax Challenges of the Digitalisation of the Economy* – Policy Note, as approved by the Inclusive Framework on BEPS on 23 January 2019, OECD, Paris.
[107] OECD (2019), Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 February – 6 March 2019.
[108] The OECD (2019) Inclusive Framework on BEPS: *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, May 2019.
[109] The OECD (2019): Public Consultation Document: *Secretariat Proposal for a “Unified Approach” under Pillar One.*
[110] OECD (May 2019) (n108) above at 11 - 23.

enterprises.[111] The aim is to ascertain whether the 'new tools' effectively achieve the purpose of reducing BEPS and discussing a possible withholding tax on digital transactions.

4.2 <u>Tax challenges of the digitalisation of the economy</u>

MNEs are able to conduct business and trade without physical presence within a specific jurisdiction. MNEs manage business operations such as procurement, marketing and distribution, centrally, where traditionally, MNEs required a local presence in the Source State to perform these operations. The 4IR has created an occurrence where a physical connection or *nexus* is no longer required between the non-resident enterprise and the Source State. The key design features of the digitalised economy places reliance on data creating challenges associated with the characterisation of and attribution of value to data. The three broad policy issues related to direct taxation are namely: (i) *nexus*; (ii) data and (iii) characterisation.[112]

4.3.1 Nexus and the ability to have a significant presence without being liable to tax

In spite of the advances in ICT, the essential features of business have remained the same. Companies still require a level of support functionality such as marketing, customer support and research in order to support their sales activities. However, ICT has impacted on how and the way these activities are carried out, this is evident through the rise of remote functionality of these support roles. Distance is no longer a barrier to trade, as physical presence and personnel are no longer required in a country, to the same extent as was previously necessary.[113] In the 4IR enterprises have the ability to choose where they set up their business activities – even if that location is removed from the ultimate market jurisdiction. Automation has created the redundancy of various people functions, and influencing many processes, including the acceptance of contracts, including e-contracts.[114] The main challenges posed by the 4IR relate to the definition of PE for the purposes of a DTA and the related profit attribution rules – the digital economy allows businesses to conduct a full scale business in a country without having a fixed place of business or a dependent agent therein, the current definition of a PE has proved to be ill-fitted for the 4IR as illustrated above.

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[111] OECD (May 2019) (n108) above at 25 – 33.
[112] OECD Digital Economy Report (n11) above at 99.
[113] OECD Digital Economy Report (n11) above at 100.
[114] OECD Digital Economy Report (n11) above at 100.

Services which were previously considered preparatory or auxiliary are specifically excluded from the definition of a PE in Article 5(4) of the OECD MTC and most DTAs, will become increasingly significant components of businesses in the digital economy. For example, an online retailer may require a warehouse close to its customers, and as such that warehouse may no longer be auxiliary but in actual fact, a crucial part of its business. The concern is such that a *nexus* goes beyond DTAs as many countries' domestic laws would not regard many of the activities performed my MNEs in the digital economy as a significant enough *nexus* as to render the MNE subject to tax under the domestic tax rules. The resultant effect this has is such that the issue of *nexus* ought to be addressed domestically and from a DTA perspective, as DTAs cannot create a tax liability.[115]

4.3.2 Data and the attribution of value created from the generation of marketable location relevant data through the use of digital products and services

ICT has created a platform enabling the use, collection and storage of data, remotely through various sources and methods. Consequently, the use of this data collection, is often utilised in the process of value creation in the digital economy. The utilisation of this data can be leveraged by businesses to enhance product offerings and to optimise products and services. In light of the expansion of the role of data, in the value chain of MNEs, questions have been raised regarding whether the current rules in relation the attribution of profits to a PE are appropriate in relation to remote data gathering. The tax challenges associated with this data, is whether the data being used is appropriately characterised and valued for tax purposes.[116] The difficulty of data value collection is that this collection is not reflected on the balance sheet of a business and is irrelevant for determining the profits of an organization for accounting and tax purposes. Further difficulty lies in legislation aimed at the protection of data – in most states the personal data of consumers is protected and the information is regarded as being the property of the individual from whom it is derived, rather than an asset owned by an enterprise.[117] The value of data collection raises questions regarding whether the remote collection of data should give rise to a *nexus* for tax purposes even where the enterprise has no physical presence and what the impact of such a nexus would be on the attribution principles for attributing value to such nexus.[118]

[115] OECD Digital Economy Report (n11) above at 102. See also De Bruyn (n30) above at 32.
[116] OECD Digital Economy Report (n11) above at 103.
[117] OECD Digital Economy Report (n11) above at 103.
[118] OECD Digital Economy Report (n11) above at 103.

4.3.3 Characterisation of income derived from new business models

ICT has ushered forward the monetisation of products and services that enterprises can offer in new and exciting ways. In the digitalised economy's novel business models are raising questions about how to characterise certain transactions and payments for domestic and DTA purposes. An example of such a scenario is whether a payment for the use of cloud computing should be characterised as a royalty fee, fees for technical services or business profits.[119] In terms of the OECD MTC, and most DTAs, business profits will be taxable in the Source State only to the extent that those business profits are attributable to a PE located in that Source State. Royalties and service fees on the other hand may be subject to withholding taxes in the Source State. The characterisation of income is therefore of great importance for tax purposes.[120]

4.4 **Proposals aimed at addressing tax challenges raised by the digitalisation of the economy**

Intricate and articulate proposals have been developed under Pillar One, in attempts to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.[121] Albeit the objective and scope of the various proposals, at the heart of these proposals, the objective is aimed at the reallocation of taxing rights. The proposals further aim to address the allocation of more taxing rights to the jurisdiction of the customer and/or user. In terms of the current taxation framework, the creation of value through business activities by a remote enterprise's participation in that jurisdiction is not fully recognised for the allocation of profits.[122] Further commonalities amongst the proposals aim to address the policy features around the existence of a nexus in the absence of physical presence; contemplation using the total profits of a business and the use of simplifying tax conventions (including those that diverge from the ALP).[123]

[119] OECD Digital Economy Report (n11) above at 106. See also De Bruyn (n30) at 32
[120] OECD Digital Economy Report (n11) above at 106.
[121] (n120) above.
[122] OECD (February 2019) (n107) above at 17.
[123] (n122) above.

4.5 Pillar One: ***Reallocation of profit and revised nexus rules***

4.5.1 The "User Participation Proposal"

The "User Participation Proposal' (UPP) was spelled out by the United Kingdom and supported by many other countries, particularly European Countries.[124] The UPP questions what is new in the system and what is new in the world, as a consequence of the digitalisation era. The UPP explores the fact that in the digitalisation era, business models allow companies to extract the data of consumers/users in one country and monetise this extraction in a third country.[125] The UPP aims to place focus only on the taxation of highly digitalised business models. In terms of the UPP, focus is placed on the value creation acquired by highly digitalised businesses through the development of an active and engaged user base and soliciting data and content contributions from those users. The UPP is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses.[126] The establishment of market power is captured through the development of a critical mass of users that participate and conduct activities that contribute to the creation of the brand and the generation of valuable data. The UPP places vital importance on the source of value on an absolute basis and relative to traditional drivers of business value, this is particularly apparent in business models surrounding social media platforms, search engines and online market places.[127]

- **Social media platforms**: these platforms are flooded with an array of user-generated content, this voluminous content and the quality thereof is a key feature of these platforms in their ability to generate revenue from those users, including the revenue generated from targeted advertisements specifically aimed at those users. Another benefit generated for these platforms is shaped through the creation of broad networks, as users build vast networks on these platforms through the fostering of connections and by encouraging others to user the platform. "A core business strategy will be to cultivate an active user

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[124] OECD Media Briefing on 9 October 2019, outlining the "Unified Approach" available at http://www.oecd.org/tax/oecd-invites-public-input-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm.
[125] OECD (February 2019) (n107) above at 9.
[126] (n125) above.
[127] OECD (February 2019) (n107) above at 9.

base and encourage them to proactively contribute content and spend time on the platform."[128]

- **Search engines**: the immense volume of content that search engines foster is delivered, directly or indirectly by users of that platform. Tailor-made and customised experiences have further been developed through the rigorous monitoring of user data, to consequently enhance the users experience on the platform. As a result of this improvement on a user's experience on the platform, users encourage others to use the platform resulting in revenue generation by "selling advertising targeted at users based on their demonstrated interests."[129]
- **Online marketplaces**: the key design features that determine the success of an online marketplace, is firstly, "dependent on the size of the user network on either side of the platform" and secondly, "the quality and diversity of goods/services those users are offering." Business strategies around online marketplaces will be to encourage and build the network. Businesses encourage and enable users to play an integral role in building and developing business models and the regulatory framework governing feedback on the quality of goods and services provided on the platform – either directly on the platform or by way of public reviews.[130]

Under the current international tax framework focus is placed on the physical activities of a business itself in the determination of profit allocations and the extent of the taxing rights of user jurisdictions and the generation of value by user participation falls through the net in user jurisdictions under existing tax rules. The effect that this creates is such that enterprises are entitled to generate significant value from a jurisdiction with a substantial and engaged user base ("user jurisdiction") without the actual revenue derived from that value being subject to local tax. The UPP aims to realign and revise profit allocation outcomes and rules with value creation, in order to accommodate the value creating activities of an active and engaged user base. Further recommendations are aimed at a revision of the nexus rules to entitle user jurisdictions the right to tax additional profit allocable to them (restricted to business models benefiting from this type of user base). For businesses that have more traditional relationships with customers, there would be no change in the profit allocation or nexus rules.[131]

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[128] OECD (February 2019) (n155) above at 9.
[129] OECD (February 2019) (n155) above at 10.
[130] (n200) above.
[131] OECD (February 2019) (n155) above at 10 – 11.

Under the UPP the intention is to ensure that intensive modifications are undertaken to traditional profit allocation rules. These modifications are aimed to ensure that "an amount of business profits is allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence".[132] The UPP acknowledges that it would be ill-fitted to address the amount of profit that should be allocated to a user jurisdiction through traditional transfer pricing methods. It further outlines the shortcomings of the current ALP in determining the value created by user activities. Under the UPP it is suggested that "the profit allocated to a user jurisdiction, in respect of the activities/participation of users, is calculated through a non-routine or residual profit split approach."[133]

The aim under the UPP, is at reallocating a proportion of the non-routine profit of the business, from the entities that are currently realising that profit, to the jurisdiction where users are located. The UPP does not intent to amend the existing rules related to the profit attributed to the routine activities of an MNE group. The UPP's main purpose is to make robust changes in calculating non-routine profit across an MNE group as well as an individual business line. A streamlined implementation is proposed whereby reliance is placed on formulae aimed to approximate the value of users and the users of each country, to a business. "it is acknowledged that this would be a pragmatic approach for allocating profits to a novel driver of value, and one that helps to avoid disputes between countries based on their subjective view of value generated by user participation. The proposal could also be combined with a strong dispute resolution component to minimise additional controversy and double taxation." The purpose of the UPP is to target highly digitalised businesses with significant user participation contributing to their value creation. A number of these business would include, *inter alia*, social media businesses, search engines and online marketplaces.[134]

4.5.2 <u>The "marketing intangibles proposal"</u>

Another proposal supported by a number of countries but mainly driven by the United States of America, is intitled the Marketing Intangibles Proposal ("MIP").[135] The foundational building blocks of the MIP direct that States should recognise more taxing rights to markets where there is an

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[132] OECD (February 2019) (n107) above at 10.
[133] OECD (May 2019) (n11) above at 12.
[134] OECD (February 2019) (n107) above at 11.
[135] (n134) above.

above normal return because then there is a sustainable engagement in the market through advertisement or through this marketing intangible and therefore, one should disentangle the market intangible from the rest of the intangible to allocate it to the market.[136] Further to the UPP, this proposal aims to change the profit allocation and *nexus* rules. The difference between the MIP and UPP is such that the MIP intends to have a wider scope of impact, in an attempt to remedy the broader impact of digitalisation on the economy and not only an application to a subset of highly digitalised businesses. The aim of the proposal is set to address situations where MNEs can essentially “reach into” a jurisdiction, remotely or through a limited local presence with the purpose of creating and developing a user base and other marketing intangibles.[137]

Fundamental to this proposal lies an intrinsic functional link between marketing intangibles and the market jurisdiction. Which, according to this proposal, manifests itself in two ways: Firstly, a variety of marketing intangibles which include, trade names and brands are reflective in the favourable attitudes of customers/users and should be seen to have been created in the market jurisdiction.[138] Secondly, customer relationships, customer lists and customer data result from activities specifically targeted at customers/users in the market jurisdiction, the MIP supports the notion that these intangibles should be treated as being created in the market jurisdiction.[139] Under the MIP an undeniable link exists between marketing intangibles and the market jurisdiction. This proposal seeks to modify traditional transfer pricing and treaty rules to “require marketing intangibles and risks associated with intangibles to be allocated to the market jurisdiction.”[140] In accordance with the MIP, it propositions that current profit allocation and nexus rules are amended and an entitlement of tax should be allocated to the market jurisdiction for some and/or all of the non-routine income properly associated with such intangibles and their attendant risks.[141] Furthermore, the existing transfer pricing and profit allocation rules would then govern the allocation of all other income (from routine functions) among members of the group, such as income attributable to technology-related intangibles generated by research and development.[142] “This is because the latter is perceived to continue to produce results that are consistent with the objective of aligning taxable profits with value creation when applied to such

136 OECD (February 2019) (n107) above at 12.
137 (n136) above.
138 (n136) above.
139 (n136) above.
140 OECD (February 2019) (n107) above at 12.
141 OECD (February 2019) (n107) above at 11 -16.
142 (n141) above.

businesses activities".[143] Consequentially, under the MIP, high importance is placed on marketing intangibles whereby market jurisdictions would be entitled a right to tax highly digitalised business, even in the absence of a taxable presence. The intention behind this proposal is consistent with the principle of allocating profits based on the fact that the creation of value by firms is created through customer information and data readily acquired through the active intervention of that firm in that market.

Large online retailers are capable of having small physical presence within a country with massive user and customer bases. Similarly, branded consumer goods companies ensure direct and digital engagement with their customers directly or through the intermediation of highly digitalised businesses, or both. With the modern-day business being online, the need for physical presence and the nature thereof becomes redundant, and consequently reduces the market jurisdiction's taxing rights. Traditionally, businesses would require some physical proximity to invest successfully into a foreign market, to establish a broad customer base and to create value – in the 4IR this is no longer the case. Business functions such as sales and marketing can all be handled remotely with only shipment and fulfilment requiring a presence (dependent on the nature of the business). "The more data on consumers that can be collected, analysed and exploited remotely through the use of digital technology, the easier it is to avoid exercising any of the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) and related risk management functions in the market jurisdiction that under today's rules govern the allocation of income from marketing intangibles."[144]

The MIP intends to impact on three key fact patterns, firstly, in instances where highly digitalised businesses derive revenue from sales and marketing activities from a market jurisdiction where it does not have a taxable presence. Under the MIP, it is suggested that non-routine profit attributable to the use of marketing intangibles (including, *inter alia*, market intangibles generated through the operation of free search services; free email; free digital storage) in those market jurisdictions are allocated, even in the absence of taxable presence. Furthermore, the proposal aims to address the shortcomings of the current nexus rules to grant the market jurisdiction the right to tax this acquired marketing intangible profit – even if the entity earning the profit would not have a taxable presence, as they currently stand in the existing nexus rules.[145]

[143] (n142) above.
[144] OECD (February 2019) (n107) above at 13.
[145] OECD (February 2019) (n107) above at 13-14.

Under the MIP, the expansion of the market jurisdiction taxation rights through a distinct allocation attributable to some or all non-routine returns from marketing intangibles would be applicable to all entities in the group factually performing or controlling DEMPE functions related to those intangibles. The allocation of all non-routine returns from marketing intangibles and the related expansion of marketing jurisdictions taxing right would apply irrespective of which entity in the MNE group owns legal title to the marketing intangibles or which entities in the group factually perform or control DEMPE functions related to those intangibles. The MIP suggests that the allocation of non-routine or residual income between marketing intangibles and other income producing factors could be determined by employing different methodologies. One of these methods would be to apply the normal transactional transfer pricing principles. Under the MIP, the application of this method would entail a determination of marketing intangibles and the contribution of profit thereof would need to be determined under a set of assumptions. Firstly, the assumption that the marketing intangibles (and their attendant risks) are allocated under the current rules[146] and secondly, this allocation is made to the marketing jurisdiction.[147] This calculation would result in a marketing intangible adjustment that is reflective of the difference between those two numbers.

Under the MIP the income allocation would be dependent entirely on the independent facts of each case and the economic contribution to profits provided by the marketing intangibles. This would entail a retention of existing rules related to identifying specific marketing intangibles and a calculation of their contribution to profit. An alternative method is deployed through the use of the revised residual profit split analysis that uses a more mechanical approximation. In accordance with any residual profit split a number of considerations should be borne in mind including, the determination of relevant profit, routine functions and their compensation, the deduction of routine profit from total profit and finally the division of the residual profit. Once the amount of residual profit is determined and subtracted from total profits various methods should be deployed to determine the portion of non-routine or residual profit attributable to marketing intangibles (including cost-based methods[148] and formulaic approaches[149]). Resultantly, once the amount of income attributable to marketing intangibles is determined it would be allocated to each market jurisdiction based on an agreed metric, such as sales or revenue. The consequence is

[146] OECD (February 2019) (n107) above at 15.
[147] (n146) above.
[148] Costs incurred to develop marketing intangibles versus costs incurred for R&D and trade intangibles.
[149] Using fixed contribution percentages, which may differ by business model.

such that the revenue of MNE groups active in the advertising industry (as many digital companies are) would be sourced by reference to the residence of the payer but by the reference to the customers that are targeted by the advertisement (the users of an online platform). The strong dispute resolution component aims to remedy any controversy and potential double taxation.[150]

4.5.3 The "significant economic presence" proposal

Finally, there was an approach supported and sponsored by India, Columbia and on behalf of the G20 (which is a group of developing countries, with their own Secretariat).[151] Working together they put forward a Significant Economic Presence Proposal ("SEPP"). The scope of which being quite limited to cases where there is a significant economic presence, meaning beyond the permanent establishment or presence through a subsidiary. But in the case of significant economic presence there should be an apportionment of profit to the market jurisdictions.[152]

The purpose and rationale behind this proposal aims to outline the ineffectiveness of current nexus and profit allocation rules given that technological advancements and digitalisation have enabled businesses with the ability to be active within the economic life of a jurisdiction without having a significant presence in that jurisdiction. The key features of the SEPP are such that "under this proposal, a taxable presence in a jurisdiction would arise when a non-resident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means."[153] The foundation of the mechanics of this proposal look at revenue generated on a sustained basis as the basic factor. Although this factor should not be viewed in isolation, accordingly other relevant factors considered listed under the SEPP include[154]:

- "the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- billing and collection in local currency or with a local form of payment;
- the maintenance of a website in a local language;

[150] OECD (February 2019) (n107) above at 15 – 16.
[151] (n150) above.
[152] OECD (February 2019) (n107) above at 16.
[153] OECD (February 2019) (n107) above at 16.
[154] OECD (February 2019) (n107) above at 16.

- responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or
- sustained marketing and sales promotion activities, either online or otherwise, to attract customers."

It is imperative that the necessary link is established between the revenue generating activity of the non-resident enterprise and its significant economic presence. Other considerations that should be addressed (in respect of revenue as a factor) include the definitions of the types of transactions that are to be covered and the corresponding appropriate thresholds. Under the SEPP, the allocation of profit insofar as it applies to a significant economic presence could be based on a fractional apportionment method[155] which would entail a three step process, namely (i) defining the tax base that ought to be divided; (ii) determining the allocation keys to divide the aforesaid tax base and (iii) the varied weighting as applied to these allocation keys.[156] Under the SEPP it is suggested that the determination of the tax base could be resolved by applying the global profit rate of the MNE group to the revenue (sales) generated in a particular jurisdiction. Consideration of factors such as sales, assets and employees should be taken into account during the apportionment of the tax base. To this extent, the SEPP acknowledges that for businesses that rely on meaningful user contribution to the value creation process, those users ought to be considered in apportioning income. The SEPP further details that reliance could be placed on simplified methods aimed at allocating profits, such as the modified deemed profits method. The SEPP further contemplates the possibility of a withholding tax as a collection mechanism and enforcement tool. "In this context, consideration could be given to a gross-basis withholding tax at a low rate on payments to an enterprise with a significant economic presence, with the enterprise having the right to file an income tax return and seek a refund if the withheld amount exceeded the enterprise's income tax liability."[157]

155 OECD (May 2019) (n11) above at 14.
156 OECD (May 2019) (n11) above at 15.
157 OECD (February 2019) (n107) above at 16.

5. An analysis of the proposals aimed at addressing tax challenges raised by the digitalisation of the economy – a South African developing economy perspective

5.1 Introduction

Despite positive strides being made on the front of international tax cooperation, it should be noted that emphasis and priority should be placed on developing economies, such as South Africa. Under UPP and MIP, emphasis is placed on the value of the market in the allocation of profits.[158] Despite businesses not having a physical presence in a jurisdiction, the UPP and MIP would afford taxing rights to these jurisdictions, based on the sustained interaction these businesses have with their economies. "These measures are achieved by deeming a portion of the non-routine profits of an MNE generated by users or marketing intangibles, and subsequently, allocating the right to tax to the jurisdiction where these users or markers are situated."[159] Under the SEPP, the proposal expressed in these proposals may be more beneficial to developing economies, such as South Africa, provided that the allocation of profits is governed through an agreed formula. Under the SEPP, emphasis has been placed on highly digitalised businesses and a jurisdiction would be afforded a taxing right where these businesses generate sustained and substantial revenue in these jurisdictions, without being physically present in these jurisdictions (possibly deeming there to be a PE). Under the SEPP, the allocation of profits would be achieved through a form of fractional apportionment with a collection and administrative element of withholding taxes governing the operation of these proposals.[160]

As illustrated above, international tax rules are on the cusp of a turning point. For South Africa, it is vital to ensure that the consensus that ought to be reached meets the needs of our developing economy, to ensure inclusivity, sustainability and maintaining the legitimacy of the international tax system. It is imperative that new rules, standards and approaches appropriately reflect the needs of our developing economy. This should encompass both the operability of the rules, where more mechanical approaches are preferable, greater access to data is supported, and further recognition should be had to the role developing economies have on influencing and impacting MNEs overall value chains. The consensus should aim to reduce double taxation and tax competition while simultaneously providing businesses with more certainty and ensure that

158 Clavey (n9) above at 5.
159 Clavey (n9) above at 5.
160 (n159) above.

developing economies are assisted to mobilise much needed resources and achieve a fairer tax revenue distribution.

According to Clavey[161]:

> "[T]he ongoing risk of BEPS arises in both highly digitalised businesses and more traditional business models, affecting both ends of the value chain. This is an important consideration for developing economies. While some represent significant markets in their own right, and markets that are increasingly digital, activity at the other end of the value chain, frequently dominated by production of raw materials and manufacture, is often a proportionately more significant part of their economies, both in terms of the operability of the rules, where more mechanical approaches are preferable, and in recognising the position of developing economies in the value chains of MNEs."

5.2 **Proposals and their impact on Developing Economies**

5.2.1 *User Participation Proposal*

Under the UPP, a key policy objective is aimed at enhancing profit arising in market economies by recognition of the value-added by users of some digital platforms. The UPP's application is focused on highly digitalised businesses that place a strong reliance on the value-add by users or consumers.[162] Users would create or add value in instances where they upload media, information or data that is available to other users via a platform, which can then monetise that data. In terms of the profit allocation, the UPP aims to dissect the portion attributable to user participation and accordingly allocate profits to the jurisdiction where these users are located.[163] The profit allocation would be ascertained by deducting, from total profit, the profits made from routine activities (this is achieved through the current methodologies outlined in methods for determining the arm's length return). This would afford jurisdictions with a taxing right, despite businesses being physically present in their jurisdictions.[164]

The UPP is attractive to developing economies as the UPP presents the potential to be governed by formulaic approaches and mechanisms. These mechanisms are capable of determining the

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161 Clavey (n9) above at 11.
162 Clavey (n9) above at 17.
163 (n162) above.
164 Clavey (n9) above at 18.

portion of residual profit allocable to user-activities, and to the allocation of that profit between countries. It should however be noted that the bulk of MNEs profit will be subject to the existing transfer pricing regime. It is yet to be seen how impactful the UPP will be on developing economies as many invariables still exist such as the measurement of user value and the type of formulae that would be adopted to determine this allocation.[165] The concern surrounding the UPP on developing economies is one that the value-add by users in developing economies is dependent on the extent that these users interact with various types of digital platforms. However, the extent of users in developing economies as opposed to developed economies is vast. Many users in developing consumers have less access to the internet and relatively low purchasing power, as opposed to their counterparts in developed economies. The UPP may have an unintended result of primary redistribution of taxing rights amongst developing economies.[166]

5.2.2 *Marketing Intangibles Proposal*

Under the MIP, the key policy objective is aimed to enhance the recognition of profit arising in market economies by a more consistent and enhanced recognition of marketing intangibles.[167] Under the MIP, the aim is to encompass all MNE businesses, and not restrict application to highly digitalised businesses. The MIP recognises that businesses have the ability to create valuable intangibles that are inherently linked to a market – without having a physical presence in that market. The functionality of the MIP would work by "determining the portion of total profit allocable to marketing intangibles by deducting from total profit the return from routine activity and the return attributable to "trade" intangibles (from example, those resulting from research and development)"[168]

From a developing economy perspective, the MIP presents attractive elements through the element that the determination of profit from marketing intangibles and the allocation of that profit between jurisdictions will be governed through the use of incorporated formulae.[169] However, the complexities of the MIP has left tax administrations much responsibility in that current transfer pricing guidelines ought to be utilised in complex situations. Under the MIP, "the focus is on value

[165] (n164) above.
[166] (n164) above.
[167] Clavey (n9) above at 18.
[168] (n167) above
[169] Clavey (n9) above at 19.

generated in markets the allocation of profits linked to intangibles specific to markets (such as trademarks) only. This means that it does not address the challenge of profit shifting through the location of often more valuable intangibles (such as software) in low-tax jurisdictions, which are the main sources of growth in digitalised economies."[170]

5.2.3 *Significant Economic Presence Proposal*

Under the SEPP, the key objective is to establish a right to tax profit of an MNE on the basis of the MNE's economic presence in a jurisdiction. Under the SEPP, jurisdictions would be entitled the right to tax businesses, even if these businesses have no physical presence in these jurisdictions, should there be substantial interaction by these businesses with these jurisdictions economies.[171] Under the SEPP, a primary factor for the determination of a business's significant economic presence would be through sustain revenue generation, however other factors would be considered, such as user base, the existence of web pages tailored to the local market and locally derived digital content.[172] It has been suggested that the allocation of profits would be governed through a form of fractional apportionment. The SEPP is a more radical approach as the proposal is not premised or governed by the identification of actual or deemed intangibles that are attributable to a jurisdiction, as is the case under the UPP and MIP.[173] Developing economies have the most to gain through an application of the SEPP. However, this is dependent on the likely value-add of the user.

> "[N]evertheless, in respect of highly digitalised businesses, the SEP proposal, provided that it incorporates a formulaic allocation mechanism, is most likely to match the needs of developing economies, and a withholding mechanism could be used to collect tax from the affected non-resident taxpayer. However, allocation formulae have yet to be determined."[174]

[170] (n169) above.
[171] Clavey (n9) above at 19.
[172] (n171) above.
[173] (n171) above.
[174] Clavey (n9) above at 20.

5.3 Potential to increase the scope of source taxation rights and withholding taxes?

It is opinioned that potential exists for jurisdictions to be afforded taxing rights over non-residents' income, which arise from specific sources. Withholding taxes would be used as the mechanism for the collection of this tax – specifically in instances when non-residents have no physical presence in a specific jurisdiction. One cannot separate withholding taxes from the right to tax a non-resident on specific or specified categories of income – these should be well established in domestic law, as well as, tax treaties, where relevant and applicable.[175] Under the proposals discussed above under the SEPP, the right would be afforded to jurisdictions to tax non-residents and under the UPP and MIP, the creation of a right to tax relevant profits at source.[176] Furthermore, the current principles governing source-taxation may be extended to incorporate and or deem digitally provided services to fall within the source principles. Utilising the imposition of withholding taxes on payments for digital services to a non-resident taxpayer would apply an established collection model to a new category of payment.[177] Withholding taxes can be an efficient collection mechanism and decrease the scope for avoidance, especially in relation to the taxation of non-residents with no physical presence in a jurisdiction (which is commonplace in highly digitalised businesses).

According to Clavey, this would apply to both B2B payment and B2C services[178]:

> "[I]n terms of B2B payments, such a system of withholding could operate alongside some of the option for taxing a share of the residual profit of MNEs discussed earlier. The withholding tax would act as a payment on account of the tax due in the source jurisdiction. The tax withheld would be offset against the final liability once it has been possible to calculate the total due on the share of residual profits attributed to that jurisdiction. This would improve cash flow and compliance but would not reduce the complexity of the profit attribution process. Source taxation could be an option for B2C services, for example include payments made from consumers to foreign suppliers of digital services, such as streaming of music and videos. If this approach is applied to the proposals under OECD's Pillar One, the amount of withholding would be representative of the tax that should be attributed to the user, or market. From a developing economy perspective, enhanced taxation in source jurisdictions adds to the tax base, and the potential to apply withholding taxes would add to the efficiency and effectiveness of tax collection and enhance cash flow."

[175] Clavey (n9) above at 21.
[176] (n175) above.
[177] (n175) above.
[178] (n175) above.

5.4 Support to adopt a "Unified Approach" – the Secretariat's Proposal

Under the Unified Approach, the OECD Secretariat has attempted to assist with the deadlock between States to encourage and facilitate conversations between countries to move the matter forward to a common approach. The Unified Approach is therefore the Secretariat's unbinding view on how the tax challenges associated with digitalisation can be addressed. The Unified Approach works (Secretary General's Report to the G20 Finance Ministers) was set to be presented to the G20 meeting on 17 October 2019 in Washington. The Secretariat proposal is designed to lead to a consensus-based solution, shaped according to what delegates would potentially agree to and is based on commonalities between the three existing proposals.[179] Most fundamentally, that means its contemplating a reallocation to market or user jurisdiction. There are, however, other commonalties that exist e.g. having a *nexus* without the requirement for a physical presence and going beyond the ALP and using simple formulaic approaches.[180] However, there is no appetite to sweep away existing ALP rules and within those constraints the proposal has been developed.[181]

As detailed above, all three proposals share common significant commonalties, despite variances regarding how these proposals aim to address the digitalisation issue regarding the nature of highly profitable and digitalised businesses and their ability to operate remotely. All the proposals suggest a method of reallocating taxing rights in favour of the user/market jurisdiction. The proposals all aim to introduce a new nexus rule that would not depend on physical presence in the user/market jurisdiction. It is apparent from these proposals that there is a departure from the separate entity principle and the traditional ALP. The main goal is to ensure simplicity, stabilisation and increased tax certainty within the international tax realm. The objective of the Unified Approach is aimed at covering highly digitalised business models but goes wider than limiting its application to same. The proposal broadly focuses attention on consumer facing businesses with further work to be carried out on scope and carve-outs.[182] The Unified Approach proposes a new nexus[183] for businesses falling within the scope, the new nexus rules, aim to be unconstrained by physical presence, and largely based on sales. Thresholds could be included under these new

[179] OECD (October 2019) (n109) above at 4-5.
[180] (n167) above.
[181] (n167) above.
[182] OECD (October 2019) (n109) above at 5.
[183] OECD (October 2019) (n109) above at 7.

nexus rules, country specific sales thresholds would be calibrated to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision. Furthermore, the Unified Approach creates a new profit allocation rule going beyond the traditional ALP. The scope hereof would apply to taxpayers within the scope, irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors.[184] The proposal largely maintains the current transfer pricing rules that are based on the ALP, but formulae-based solutions are proposed to complement the ALP in areas where tensions in the current system are the highest.[185]

The new approach aims to co-exist with the existing ALP – a new approach and an infrastructure for the new approach need to clearly deal with the interaction. The way the OECD proposes to do that is to approach the new taxing right as an overlay to the ALP and in the process limiting that overlay to the greatest extent possible. The OECD aims to create the overlap or interconnection between the two systems (the existing ALP system and the new taxing right) at what they see as the weakest part of the ALP system, namely where residual profits exist. What that means is that the OECD aims to target the upper level of profitability of the more profitable companies as the point where the OECD deals with that interaction. The new system is therefore an overlay or partial overriding at that particular point. The core elements of the Approach are such that the OECD is creating a new taxing right, trying to improve the operation of the ALP, and trying to improve dispute resolution and prevention. The new approach to income allocation goes beyond the existing system in a number of ways – so that means the OECD also needs to create a new infrastructure and the OECD is attempting to do that in the least complex way by using formulae and proxy where they can and generally trying to operate the system of having the least complex step at every stage in the new approach. But that also means there are going to be trade-offs in the application of what the OECD is attempting to achieve.

The two critical dimensions of the unified approach are (i) scope[186] and (ii) nexus.[187] Firstly, the core element of scope attempts to net in large sized MNE groups and businesses, a potential indictor of this would be global revenue. The scope would not be restricted to digital business but also consumer facing businesses. This would be enterprises likely to derive meaningful value from interactions with consumers/users in markets – businesses with highly digitalised business

[184] OECD (October 2019) (n109) above at 7-9.
[185] (n172) above.
[186] OECD (October 2019) (n109) above at 7.
[187] OECD (October 2019) (n109) above at 7.

models[188] and consumer facing businesses, including B2C and some B2B (such as sales of consumer products through intermediaries). It aims to exclude extractive industries from the scope, while further discussion is needed to determine whether commodities would be included in the scope.[189] Secondly, the other fundamental building block would be the new nexus rules that are unconstrained by physical presence. In an increasingly digitalised economy, large businesses conduct consumer and/or user facing activities remotely. New nexus rules would measure an MNE groups sustained and significant involvement in the economy of a market. Several indictors that ought to be considered would be a revenue threshold, with adaptations to take into consideration the size of the market jurisdiction and their economies; a time threshold and potentially other indicators of in-scope activities carried on in the market.[190] What is important is to not disrupt the system that exists in bilateral treaties (for e.g. the concept of PE that exists there as a nexus) but rather assessing the global assessment of the activities of a group and the application of this provision in many different countries. The OECD is avoiding changing existing concepts in bilateral treaties of PE that would create a spill-over effect. Once you have an MNE and that MNE falls within the scope and there is an identified nexus with a particular market jurisdiction the next question is how much profit would be allocated or that a jurisdiction would be entitled to tax.[191] The unified approach aims to ensure tax certainty and administration consisting of a three-tier profit allocation mechanism, as follows:

- Amount A: a formulaic approach used to allocate a share of deemed residual profit to market jurisdictions, based on group/business line profits (new taxing right to market/user jurisdiction).This would be independent of physical presence, with no links to ALP;[192]
- Amount B: baseline marketing and distribution functions conducted in market jurisdictions would receive a fixed remuneration (concerned with the improvement of the existing ALP system);[193]
- Amount C: enhanced binding dispute prevention and resolution mechanisms that effectively complement all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.[194]

188 Such as intermediation platform and online advertising.
189 (n175) above.
190 In-scope activities related to the users, looking at whether users are carrying on those activities within those markets.
191 OECD (October 2019) (n109) above at 7-9.
192 OECD (October 2019) (n109) above at 6.
193 (n181) above.
194 (n181) above.

- Amount B and C – there is no new taxing right, merely a modified operation of the ALP, following the separate entity approach.

5.5 Conclusion

It is arguably the biggest concern that the proposals discussed would affect all profits and not only profits that have been shifted to lowly taxed entities. The proposals aim at an overall redistribution of taxing rights over the profits attributed to those jurisdictions. The proposals still fail to catch profit diversion that is unrelated to user participation or marketing intangibles. It is argued that based on this reasoning the utilization of these proposals limit developing economies. From a technical and practical perspective, it is imperative that consideration of how taxing rights are to be established is vital. This may take the form of an extension of the PE principles, or the determination of an additional source taxation right. Other changes to the model tax conventions will be necessary too. To ensure speedy implementation of these changes, the existing Multilateral Instruments will need to be amended or supplemented

6. Conclusion

The current taxation framework is under immense strain given the key features of the digital economy that place reliance on mobility, on data and multi-faceted business models. Businesses are now able to leverage global chains from anywhere in the world, no longer being bound to a specific geographical market. The traditional confines of age-old tax principles outlining PE and the attribution of business profits are ill-equipped for the digital economy. Various options have been considered by the OECD, which are built on the two foundational Pillars focusing on the allocation of taxing rights and undertaking a review of the profit allocation and *nexus* rules as well as global anti-base erosion.

After consideration of the above, it is submitted that it is clear that the current taxation framework is no capable of adequately addressing the tax challenges posed by developments in ICT in the digital economy. An unequivocal response from countries across the globe is therefore necessary to prevent their tax bases being eroded through the digital economy's proliferation of BEPS. It is submitted that it would however be nearly impossible for the South African government to implement certain amendments unilaterally. A multilateral approach would be the only effective approach in combatting BEPS in the digital economy. Consideration ought to be had to the effect certain proposals would have on developing economies. The writer hereof is of the opinion the "Unified Approach" would be best equipped at reaching a swift global-consensus. The proposal was developed by an independent party free from political bias, that takes into consideration all the proposals to imbody all the key features and underpinnings into a single unified proposal.

Certain business models in the digital economy, including online advertisements are targeted at specific jurisdictions. Profits are often derived through specific, measurable models, such as the pay-per-click model, where advertisers pay per view by a consumer. Advertising intermediaries act as central points for advertisements in a country and could possible act as withholding agents for the withholding tax. The advertising intermediaries already collect information, such as the number of clicks and specific jurisdiction from which the profits are derived, as this forms the basis of how their clients are charged. As the information is already collected, it would not be exorbitantly expensive for SARS to collect information on the revenue derived from advertisements in South Africa. SARS could therefore use this business model as a trial run for some of the proposed options.

The writer hereof believes that the Unified Approach should form the foundational building blocks in creating a global-consensus by 2020. It is opinionated that there is room to increase the scope of source taxation rights and an ideal mechanism for the collection of these taxes is through the embodiment of withholding taxes. It is important countries agree on something that they would implement, there would be no need to change the rules if the USA (key partner) where you have a number of companies that is not in a position to agree. There is no way to design a solution where a number of European countries would say that we walk away. There is no way to design a solution where big emerging and developing economies would walk away (China, Brazil, India). Further there is no way to design a solution where a number developing countries say there is nothing in it for them, and they walk away. Secretariat proposal aims to provide elements of the conflicting proposals in such a way that countries could potentially agree, to reach a global-consensus within the timeframe of 2020.

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